

The New York Certified Public Accountant



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Managing Editor

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STATE SOCIETY ACTIVITIES

Calendar of Events

October 9—Regular meeting of the Board of Directors.

October 9—7:30 P. M.—Regular meeting of the Society. Location: Waldorf-Astoria Hotel, Lexington Ave. & 49th Street, New York
Subject: To be announced.

October 16-19—Annual Meeting of the American Institute of Accountants, Hotel Jefferson, St. Louis,

November 27—Regular Meeting of the Board of Directors.

November 27—7:30 P. M.—Regular Meeting of the Society. Location: Waldorf-Astoria Hotel, Lexington Ave. & 49th Street, New York.
Subject: Federal Taxation.

December 11—Regular meeting of the Board of Directors.

December 11—7:30 P. M.—Regular meeting of the Society. Location: Waldorf-Astoria Hotel, Lexington Ave. & 49th Street, New York.
Subject: State Taxation.

Address Changes

The 1944 Year Book of the Society will go to press with the membership list as of November 1st 1944.

Your attention is called to the ruling of the Board of Directors that members are responsible for the reporting of changes in address and that no individual request for change of address will be sent out for the listing in the Year Book or Directory of Members.

Change in Publication Year

Attention is called to the change in publication year of The New York Certified Public Accountant. This

issue which would normally be Volume XV, Number 1, is Volume XIV, Number 13. The November and December issues will be included in the present volume and Volume XV will begin with the January issue and consist of the twelve issues of the calendar year.

Committee Chairmen Meeting

On September 25, 1944, the chairman of the Society's standing and technical committees met for dinner with the Board of Directors at the Waldorf-Astoria Hotel, New York City, with President Saul Levy presiding. The meeting was honored by the presence of a number of past presidents of the Society: Messrs. Robert H. Montgomery, P. W. R. Glover, Walter A. Staub, Joseph J. Klein, A. S. Fedde and J. Arthur Marvin.

President Levy, after introducing the past presidents, turned the meeting over to President-elect Henry A. Horne who, in turn, called upon First Vice President-elect William R. Donaldson to introduce the chairmen of the standing committees, and upon Second Vice President-elect Prior Sinclair to introduce the chairmen of the technical committees. A number of the chairmen of these committees described the work of their particular groups.

Correction

In the September 1944 issue the name of William Goffen the author of "Stabilization of Wages and Salaries in War Time", was erroneously printed as William Gotten. The editor extends his apology to Mr. Goffen.

Change in Taxation Committees

The Board of Directors of the Society, at its meeting on September 25, 1944, unanimously concurred with the recommendation of the incoming administration, presented by President Levy, that the Standing Committee on Taxation be eliminated and that the Technical Committees on Federal Taxation and State Taxation be made Standing Committees.

New Staff Addition

Edward J. Gleason has joined the staff of the Society as assistant executive secretary and will handle public information work, in cooperation with the Society's Committee on Public Information, formerly

known as the Committee on Public Relations.

Deaths

Seymour J. Levenson

Seymour J. Levenson, a member of the Society since November 1924, passed way in June 1944.

Emanuel R. Wilhelm

Emanuel R. Wilhelm, a member of the Society since September 1943, passed away on October 1, 1944.

The Society has suffered a great loss in the passing of these valued and esteemed members.

Let Your Heart Decide

SUPPORT THE

NATIONAL WAR FUND

Announcement of **1945 PRIZE ESSAY CONTEST**

The Board of Directors of the Society has authorized the Committee on Publications to conduct a prize essay contest, the essays to be on a subject of interest to the accounting profession and suitable for publication in The New York Certified Public Accountant. Prizes in the amount of \$150 for first prize, \$100 for second prize, and \$50 for third prize are offered.

The general rules of the contest are as follows:

All papers shall be original and the manuscript shall be typed in duplicate on 8½ x 11 stationery, double or triple space typing, and should not be more than 5000 words.

★

The name of the individual submitting the paper should not appear thereon, nor should there be any other means of identifying the manuscript, which should be accompanied by a covering letter giving the contestant's name and address.

★

When submitted to the judges, each manuscript will be given a key number of identification.

★

Manuscripts should be forwarded to The Managing Editor of The New York Certified Public Accountant, 15 East 41st Street, New York 17, N. Y., on or before May 1, 1945. Awards will be announced as soon thereafter as possible.

★

All papers submitted shall become the property of the New York State Society of Certified Public Accountants and shall be available for publication in The New York Certified Public Accountant. The decision of the judges shall be final as to what papers may be entitled to prizes.

PROFESSIONAL COMMENT

Statement by Practice Procedure Committee Regarding an Accounting Problem Resulting from the Recent Change in the New York State Franchise Tax Law

The committee believes most members of the Society are familiar with the changes recently effected in the New York State franchise tax law. It is therefore not the purpose of this statement to describe these changes in any detail but the committee believes a statement regarding one accounting problem which arises therefrom will be helpful to the membership of the Society.

The new law has the effect of closing the gap between the period on the income of which the tax is based (the base period) and the period in which the corporation is privileged to exercise its franchise or do business in the State (the privilege period). In the case of a corporation on a calendar year, the return filed May 15, 1943 was based on income of 1942 and was for the privilege of operating from November 1, 1943 to October 31, 1944; the return filed May 15, 1944 was based on 1943 income but the privilege period covered is for only two months under the new law, November 1, 1944 to December 31, 1944; the return to be filed May 15, 1945 will be based on 1944 income and will be for the same privilege period as the May 15, 1944 return, that is November 1, 1944 to December 31, 1944.

In the past, corporations on the accrual basis have accounted for their franchise taxes under one of the following methods: (1) the tax was spread over the privilege period to which it applied, (2) the tax was charged against income of the year

in which the return was filed, (3) the tax was charged to income of the year on which it was based.

A corporation on a calendar year, following the first method, would have charged 1943 income with 2/12ths of the tax shown on its return filed May 15, 1943. In its balance sheet at December 31, 1943 it would have deferred 10/12ths of the tax shown in the return filed May 15, 1943 which 10/12ths should be charged against 1944 operations. The same corporation filed or will file returns on May 15, 1944 and May 15, 1945, the first return being based on 1943 income and the second return being based on 1944 income. The committee recommends that all of the taxes shown on May 15, 1944 and May 15, 1945 returns, as well as the 10/12ths deferred at December 31, 1943 be charged against 1944 operations.

Under method 2, the committee recommends that a company on a calendar year should charge against 1944 income not only the tax shown on the return filed May 15, 1944 but also the tax shown on the return due on May 15, 1945.

Under method 3, a calendar year company would have accrued in 1942 the tax based on 1942 income and would have accrued in 1943 the tax based on 1943 income. Therefore, such a company would charge against 1944 operations only the tax based on 1944 income as shown by the return to be filed May 15, 1945.

The same procedures, with suitable modifications, would be applicable to fiscal year corporations, depending on whether they had been accounting for their franchise taxes under method (1), (2) or (3).

If the committee's recommendation is followed it will mean that, in

many cases, income of the calendar year 1944 or the fiscal year ending 1944 or 1945 will be charged with several New York franchise taxes which together may be substantially greater than a normal charge. If the amount of tax to be charged against 1944 income is sufficiently material, it may be desirable to deduct the tax based on 1944 net income (or based on income of a fiscal year ending in 1944 or 1945) as a current operating charge and the balance of taxes, based on income of prior years, as extraordinary charges. While the committee recommends that the entire amount be charged against income there may be extraordinary cases in which circumstances may justify a charge to surplus, with full disclosure, of the amount in excess of the tax applicable to the 1944 basic (income) year.

It should be noted that this statement does not attempt to cover the question of the deductibility of the New York State franchise tax in federal income tax returns.

NACA Appoints National Secretary

The National Association of Cost Accountants recently announced the appointment of Wyman P. Fiske as secretary of that organization. Mr. Fiske, who served NACA as its national president in 1942-43, is on leave of absence from his responsibilities as Professor of Accounting and Director of the Sponsored Fellowship Program at Massachusetts Institute of Technology. As secretary of NACA he succeeds the late Dr. Stuart C. McLeod.

Treatment of Terminated War Contracts in Financial Statements*

A STATEMENT BY THE RESEARCH DEPARTMENT OF AMERICAN INSTITUTE OF ACCOUNTANTS

This statement deals with the treatment in financial statements of

accounting matters incident to the termination of fixed-price supply contracts for the convenience of the government. It does not deal with terminations made because of the fault of the contractor, nor with terminations of facilities or cost-plus-fixed-fee contracts.

It is the purpose of this statement to outline the various problems which will arise, and while no definite conclusions are reached, it is hoped that the statement will stimulate thinking and discussion on this very important subject. The research department of the American Institute of Accountants will welcome comments and suggestions.

As a basis for the discussion of the technical accounting problems, it may be advisable first to indicate the nature of the termination process.

Nature of the Termination Process

Wherever possible, terminations are intended to be made after discussion of the status of the contract between the contractor and the contracting officer. The typical terminated contract ordinarily will involve some completed articles ready for delivery; some articles so nearly finished that the actual date of termination may be fixed by the government so as to permit completion of such articles; partly processed articles; purchased parts; and raw materials. In some cases, however, there may be no inventory at all, but only accumulated charges for preparatory and preoperating expenses. There may also be facilities acquired solely for the terminated contract, the unamortized cost of which may be chargeable to the government.

In accordance with the uniform termination article for fixed-price supply contracts,¹ upon termination of a war contract the government immediately becomes liable to the

* Reprinted from the October 1944, JOURNAL OF ACCOUNTANCY.

¹ Uniform Termination Article for Fixed-Price Supply Contracts, released by directive order of the Director of War Mobilization, dated January 8, 1944.

contractor for fair compensation, and, to the extent and at the times directed by the contracting officer, the government may acquire any tangible assets involved. As to the terminated portion of the contract, unless otherwise specified, the contractor has no further service to perform, except in respect of post-termination expenses which are reimbursable, and he has the right to bill the government immediately for amounts owing on such terminated portion, including a reasonable allowance for profit. Even where the contractor elects to retain some or all of the assets subject to the termination, he has the right to submit a claim against the government for the costs and any profit thereon, the assets retained being in the nature of a repurchase from the government at an agreed-upon value.

Small, simple termination claims can ordinarily be processed immediately and quickly. Where the amount is large, however, the probability is that the settlement proposal or claim will be somewhat complex; that some time will be required for its preparation; and that further time will be required for its approval by the government. Some claims may have controversial points which will require discussion or investigation and, therefore, will not be determinable with finality in advance of the settlement negotiations; in such cases, delay in final settlement as indicated hereinafter, will be inevitable. On the other hand, it is reasonable to suppose that there will be many claims where the amount of the ultimate settlement can be estimated with reasonable certainty within a fairly short time after the date of termination.

One of the primary objectives of the Contract Settlement Act of 1944² is "to assure to prime contractors and subcontractors, small and large,

speedy and equitable final settlement of claims under terminated war contracts." In order to carry out this objective, the Act specifically provides that "termination claims shall be settled by agreement to the maximum extent feasible." Therefore, while some claims may be settled finally on the basis of meticulous cost determinations and a fixed ceiling on profit (a formula settlement), most claims will probably be settled by negotiation between the contractor and the government. In such negotiations, controversial points will necessarily be settled on a give-and-take basis, and profit allowances will be settled on a reasonable rather than a formula basis. Nevertheless, the entire foundation of a claim and its allowance, as set forth in the uniform termination article, is reimbursement for costs incurred plus a reasonable profit, and any settlement proposed by a procurement agency which does not meet that test can be appealed by the contractor, within the procurement agency, to an appeal board, or beyond that, to the courts. With further provisions in the Act for liberal advance or partial payments, the contractor appears to be protected against arbitrary methods on the part of government officials, and should be able to recover his costs, plus a profit at least approximating the ceiling percentages provided for use in formula settlements.

In many cases the contractor will elect to retain finished articles, partly processed items, or raw material, as either usable material or scrap. The contractor's claim in such cases may properly include the cost of such items and a reasonable profit thereon. However, a disposal credit would be made against such claims, representing the value agreed upon for the items retained, which is in effect a repurchase of the items by

² Public Law No. 395, 78th Congress, 2nd Session, approved July 1, 1944.

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the contractor from the government at the agreed-upon amount.

Nature of the Accounting Problems

The accounting problems involved in termination are similar to others which have arisen out of the war³ in that they have arisen so quickly and in such significant amounts that it has not been possible to develop applicable, generally accepted accounting procedures by experience with the problems over a considerable period of time. The problems are complex, and while they have points of similarity to many accepted practices, they also have points of difference which are of equal importance.

In the supplementary research bulletin dealing with renegotiation,⁴ the statement was made that "provision should be made in financial statements for all liabilities that can be reasonably estimated." In the bulletin on CPFF contracts,⁵ the conclusion was reached that "the fee should be accrued as it is billable" rather than as it is billed. The present problems also include the question of dealing with a "profit" accruing at a specific date, which may be difficult of determination; with respect to which reasonable calculations will require informed judgment; and as to which final determination may, but should not ordinarily, be delayed. Nevertheless, for accounting purposes, it is essential that agreement be reached as to the date when profit accrues, even though, as with renegotiation refunds, tentative financial statements and subsequent retroactive corrections thereto may be necessary.

When Does Profit Accrue?

The incidence of "profit" is the most important phase of the prob-

lem. Profit on termination settlements may affect the income-tax provision and the determination of a renegotiation refund. Both taxes and renegotiation, therefore, are likely to be affected by the decision as to whether generally accepted accounting practice requires accrual of profit at the date of termination or whether no accrual is permissible prior to final settlement. If the "profit" does not accrue at date of termination, is it properly accruable at any date short of final determination?

Profit ordinarily accrues when a sale takes place, and delivery or performance is the usual test of a sale. It has already been demonstrated, however, that, due to the peculiar nature of contracts with the federal government during wartime, delivery may not always be the sole or even principal criterion of a sale.⁶ The further exception to be considered here is whether the time required for calculation or the difficulty of making a reasonable determination prior to settlement of a terminated contract require that the ordinary rule as to profit be set aside.

Some objective criterion for the accrual of profit must be used. While the date of termination or date of settlement seems to be the only truly objective criterion, the latter date loses this characteristic when the contractor is in a position to delay settlement at his convenience, such as to obtain more favorable results in renegotiation or taxation. Such delays also seriously hinder the speed of reconversion. A date such as that when the claim has been prepared, or when the area of doubt is discernible, however, would

³See Accounting Research Bulletins Nos. 19, 15, and 21 dealing with CPFF contracts and renegotiation, and Statements on Auditing Procedure No. 20, dealing with examination of contractors' claims under terminated contracts.

⁴See Accounting Research Bulletin No. 21.

⁵See Accounting Research Bulletin No. 19.

⁶See Accounting Research Bulletin No. 19, dealing with accounting for CPFF contracts.

also leave the accrual of income on purely subjective grounds.

The question, therefore, is whether in most cases a reasonable estimate of the amount of a termination claim can be made shortly after the termination date and prior to the time of ultimate settlement. Exceptional cases should no doubt be treated as exceptions, and need not control the answer to this question.

If one were dealing only with the amount of profit, as such which is allowable on a termination claim, the amount in most instances might not be significant enough to require serious consideration. With a ceiling of 6 per cent on costs allowable on a formula basis and the natural tendency for such a ceiling to have some influence on the amount allowable in negotiated settlements, the "profit" might not always be significant in relation to the assets or net income of many contractors. But the actual income to be taken up in the accounts is the difference between the amount of the termination settlement and the inventory and other capitalized amounts applicable to the terminated contract. Since some costs, such as general and administrative expenses, are allocable to terminated contracts and recoverable in settlement, but are usually charged off on the books of account currently in accordance with the contractor's usual accounting practices, the actual book income on termination may be a significant amount in many cases.

In some cases the entire amount allowed in termination is for items or costs previously charged off on the books, and in others the actual inventoried amount is but a small part of the claim. With large claims a larger amount is likely to be represented by tangible assets or inventories at customary factory cost, but even in such cases the amount of the claim at full recoverable cost is frequently such as to result in substantial income, entirely aside from the

profit allowance. In most cases, therefore, the book income on termination settlements will probably be due much more to the recovery of uncanceled costs than to the profit allowed under the contract article.

Necessity of a Reasonable Determination

The crux of the accrual of "profit" problem is whether the amount of the claim can be determined on a reasonable basis prior to final settlement. For this purpose a precise determination should not be required.

As to the profit allowed on the claim, the amount is ultimately controlled by the government in the negotiated settlement. However, this amount is not to be decided on mere whim and may be related to past allowances or to the standards applicable in a formula settlement. It might well be maintained that, for financial-statement purposes, accrual of profit on the basis of the ceiling provided in the formula is a reasonable method in the absence of other data. But, as previously indicated, the major part of the income to be dealt with is likely to represent costs previously written off. The problem, therefore, is primarily whether allowable costs can be determined with sufficient accuracy to bring the amount of the claim within the requirement of a "reasonable determination."

The difficulties involved in the preparation of a termination claim on the basis of costs are rapidly being overcome. While at first claims were being reduced on the average by as much as 30 per cent in final settlement, more recent statistics indicate that the extent of reduction has declined materially and is approaching an average rate of 10 per cent. The area of doubt and uncertainty has already been greatly narrowed, and, with the passage of the Contract Settlement Act of 1944, and the organization of the Office of

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Contract Settlement contemplated in the Act, that area should be further reduced. There will, of course, still remain some areas where honest men may differ, and where controversy may have to be settled by investigation, by use of independent public accountants, or by negotiation. Also, because some claims are simple and others quite complex, the area of doubt may in some cases be highly significant in relation to the income of the contractor for a fiscal period. Even in these cases, however, the doubtful areas are being reduced to a minimum by the process of predetermination of termination settlements, whereby the government and the contractor agree upon as many phases of the termination settlement as possible prior to actual termination.

The large-scale educational program now being launched by the army, establishment of termination departments by many corporations, improvement in government practices, and the experience in actual terminations, will certainly facilitate the making of reasonable determinations of termination claims in more cases than formerly. This is likely to be true particularly of the larger companies whose stock is publicly held and which publish periodic financial statements. As in the case of income taxes, the information regarding termination policies, procedures, and standards is now available. Lack of knowledge, therefore, seems no more excusable for a failure to estimate termination claims than it is for a failure to provide for the income-tax liability. Certainly, estimating costs is nothing new to industry.

The time required for determination of the amount of a claim is important. Accounts cannot be held up indefinitely to satisfy meticulous accounting requirements. On the basis of experience to date, it is fair to state that complex claims, which

include most large ones, require around sixty days for their preparation, though many debatable points may be settled before the final claim is submitted. Another sixty days may be required before the government identifies the debatable items. Thus, some companies, whose contracts may be canceled at the end of the fiscal year, may not have sufficient data to permit any estimate of the amount of the claim in time for reflection in the annual report to stockholders. For most companies, however, it is quite likely that contract cancellations will occur at various times during a fiscal year, and that at least the original calculation of a termination claim may be made before preparation of the annual report to stockholders. In the case of companies having particularly troublesome termination problems, reports to stockholders might be held up pending settlement thereof; just as some companies have done in respect of unsettled renegotiation proceedings.

Influence of Conservatism

Perhaps the easiest procedure in accounting for contract termination would be to carry forward the book balances of items applicable to the terminated contract. This method obviously has the virtues of conservatism and simplicity. Nevertheless, if conservatism, as many believe is proper only in an area of doubt, and is not proper merely as a reason for delaying the recognition of an otherwise determinable amount, then the method of carrying forward only the book balances would be proper only when no more accurate determination of the claim is possible. Where the amount of a termination claim is reasonably determinable, but the contractor hesitates to recognize its full amount prior to ultimate settlement, in view of possible unforeseeable reductions therein, the claim could be reflected in the ac-

counts and financial statements at its full amount and a precautionary reserve provided for any possible reductions therein.

Is a Termination a Sale?

If, in a given case, the contractor at termination has performed all he is required to perform, except for services in respect of the settlement for which he is entitled to reimbursement, and the government has the right to the tangible assets and must pay for them, there is reason to believe that all the elements of a sale are present. On the other hand, delivery may not take place and the transaction may, therefore, not be one which is customarily regarded as a sale in the normal course of business. However, as already indicated, the peculiar nature of government war contracts and the circumstances of their settlement in certain cases are such that delivery may not always be a satisfactory test of a sale.⁷ There may also be cases where articles completed or to be completed are to be delivered to the government under the termination, while raw material or part of the work in process are to be retained (reacquired) by the contractor.

If a termination is held to be a completed transaction, whether delivery takes place or not, and the profit held to be properly taken up at time of termination, would it be preferable to treat the gross amount of the claim as a sale, and include the full amount in sales for the year, or would it be better to deal only with the book profit and show that amount as a separate item of operating income?

In answering each of the foregoing questions, a case can be made for each side, just as was true for the treatment of costs and fees on CPFF contracts.⁸ Practical utility may have

some influence, such as the desirability for purposes of renegotiation, that all government contracts, including terminated contracts be considered together.

Disposal Credits

Another matter requiring consideration is the treatment of disposal credits involved in a termination settlement. Such credits will arise from retention (reacquisition) by the contractor of some or all of the inventory subject to the termination or disposal thereof to a third party. In either case, the amount of the credit will represent an agreed-upon value for the items, either for further use or as scrap.

To the extent that the termination claim includes charges for inventory items expected to be retained by the contractor, and the claim is treated in the accounts as a sale, as indicated above, the retention of such items would be in the nature of a repurchase by the contractor from the government at the agreed-upon amount and probably should be so reflected in the financial statements. Where such items are transferred to a third party, the disposal credit merely represents the payment therefor from that source, rather than from the government.

There will be cases where a contractor makes no claim in connection with a terminated contract. In such cases the accounting problems would be only those of accounting in the usual manner for the tangible items retained.

Balance-Sheet Problems

There is the question of whether the change in the form of a terminated contract, from an active contract in process to a claim against the government, precludes the classification of the claim or related assets

⁷ See Accounting Research Bulletin No. 19.

⁸ *Ibid.*

in the current-assets category on the balance-sheet. Under the current practice there would appear to be no basis for their exclusion from current assets, since the amount is represented in the ordinary flow of business; it is part of the working capital; and, as evidenced in the Act, it is expected to be paid promptly; and substantial loans or advance payments can be arranged.

Since a termination claim and related items represent an unusual situation, separate disclosure in financial statements might be required when the amount is significant, accompanied perhaps with a statement of the basis on which the claim is computed. The question of separate disclosure, however, is somewhat controversial, because, for practical reasons, there may be objection to showing a claim on a terminated contract in financial statements at an amount differing from that filed with the government, or to show as an asset the full amount of a claim which includes controversial items.

When a claim includes items as costs which are carried in financial statements as deferred charges or as fixed assets, should such portion of the claim be included as current assets? The answer would depend on whether the transaction is determined to be completed and subject to accounting treatment as of the date of termination.

One of the objectives of the Contract Settlement Act of 1944 is to assure to prime contractors and subcontractors adequate interim financing until final settlement of claims. In the case of such interim financing, the question arises as to the proper balance-sheet treatment of payments on account of termination claims. Two accounting research bulletins dealing with wartime problems indicate that either (a) deduction of such payments from the claims or related asset account, or (b) presentation as

a current liability, would be acceptable, provided the amount and nature of the items and their relation to the termination claims are adequately disclosed.⁹

Post Termination Costs

Post-termination costs are costs incurred after the termination which relate to the terminated contract. They are specifically allowable as reimbursable items under both the Act and the uniform termination article. While in a different category from costs incurred prior to the termination, the allowability of post-termination costs should be readily determinable, thus warranting their being carried as receivables on the balance-sheet or as part of the separate showing of the claim.

Subcontractors' Claims

Many contractors will have a claim for their own work as well as for charges of subcontractors. The prime contractor is liable to the subcontractor for the amount of the latter's claim. While a contractor can be responsible for rapid and reasonable calculation of his own claims, he cannot very well force a subcontractor to be prompt or accurate. On the other hand, the contractor can collect from the government for the claims of subcontractors applicable to the termination contract.

The question arises as to whether it is necessary to set up as a liability the estimated amount of subcontractors' claims. Such treatment would probably be required under normal commercial procedures, but the possibility of loss to the contractor, or of involuntary payment of such claims from his own funds, is so remote under the Act as to suggest that it should not ordinarily be necessary to set up subcontractors' claims as liabilities, unless they have been included as assets or payment thereon has been received from the government.

⁹See Accounting Research Bulletins Nos. 14 and 19.

The Functions of Public Utility Depreciation Accounting

By JOHN BAUER

THE article by Dr. Herbert B. Dorau, in the June 1944 issue of the NEW YORK CERTIFIED PUBLIC ACCOUNTANT, on "The Economic Implications of Public Utility Depreciation Accounting," was directed against the depreciation standards and procedures as recommended by a special committee of the National Association of Railroad and Public Utilities Commissioners (NARUC), and as prescribed in the Federal Power Commission's (FPC) official accounting classifications.

Inasmuch as the article reached many professional accountants, financial analysts and others interested generally in sound public standards of industrial control, but who have not lived in the struggles for effective public utility regulation, I venture to present what, it seems to me, is involved from the standpoint of desirable and effective public utility regulation. The NARUC and FPC accounting standards should be considered as part of the technique and procedure essential to effective regulation.

The trouble with past regulation has centered particularly in the fixing of rates. The standards for this purpose were set many years ago by the Supreme Court in the famous case of *Smyth v. Ames* (1898).⁽¹⁾ This established as the general criterion of reasonable rates a *fair return on the fair value* of the properties devoted to public service. The "fair value" was never precisely defined, but it came to be regarded as consisting primarily of "reproduction cost less depreciation," although

original cost and other factors were to be given proper consideration.

No extensive survey of the Supreme Court cases dealing with "fair value" and rate making procedure will be undertaken. But, under past decisions and opinions the "fair value" standard was not only indefinite as to concept but it required physical appraisal of the properties as a part of a formal rate case. This applied both to the reproduction cost of the properties and to their depreciation. It involved costly investigations, conflicts of interest between investors and consumers, protracted hearings, unsatisfactory decisions and, to large extent, deadlock in regulation.

The suitability of "prudent investment" vs. "fair value" has been urged upon the Supreme Court continuously even when reproduction cost appraisal appeared to be solidly established as the law of the land. After the 1929 financial collapse, the Court began to relax on the reproduction cost requirement⁽²⁾ and has since completely abandoned the "fair value" formula. This was finally accomplished in the *Hope Natural Gas Company* case decided on January 3, 1944.⁽³⁾ Under the new rulings, the commissions entrusted with the responsibility of regulation are now free to establish standards, techniques and procedures which are specifically designed to effect the twofold purpose of protecting systematically both the private and public interests in the organization and management of the vital utility industries.

(1) 169 U. S. 466.

(2) *Los Angeles Gas & El. Co. v. RR. Com.*, 289 U. S. 287 (1933).

(3) 320 U. S. 591.

The Functions of Public Utility Depreciation Accounting

In view of the new possibilities of establishing definite and regular administration, there is particular need of clarification as to what is involved in regard to objectives, the basic interests, and the means through which effective regulations can be attained. The efforts of this article will be to outline the general function of accounting, and particularly to clarify the depreciation standards and provisions which are an integral part of the total accounting in the modernized system of public utility control.

Misconceived Implications

In summary form, the economic implications as presented by Dr. Dorau are that the NARUC and FPC depreciation accounting would result in unfairness to investors, in confiscation of their properties, or in depriving them of a fair return. On the second page of his article he refers to the "radical changes" in the accounting for depreciation, and states: "The issue is important because the clearly indicated purpose of 'depreciation' accounting is to substitute an amortization or liquidation reserve for a depreciation reserve."

While I do not agree in full with the NARUC recommendations, nor necessarily with all the FPC requirements, I believe that Dr. Dorau has misconceived their purpose, that his entire discussion involves perspectives which are foreign to their provisions. The alleged implications appear to me as non-existent. First, the accounting applies in fact to depreciation, not to amortization and liquidation. Second, it does not intend to, and cannot, confiscate any properties or deprive investors of basic rights. On the contrary, it is specifically designed, as part of the total plant and operating accounting, not only to show definitely what the private investments have been, but also to assure their full maintenance

and to prevent impairment and dissipation through such managerial design and manipulation as in the past have caused the loss of billions to innocent purchasers of public utility securities.

The special accounting provides for equal determination and protection of public and private rights. In considering its valid implications, one must have in mind the economic and legal status of the public utilities, the reasons for public regulation, the unsatisfactory past results, and the requisites to make future regulation effective in assuring full and equal protection to investors and consumers, particularly in preventing impairment or confiscation of legitimate investments devoted to public use.

In regard to the economic status of public utilities, the fact should be clear that they are inherently natural monopolies, and furnish vitally important services for all industry, commerce and social life. While they are privately organized, they are engaged in public service, and are vested legally with special public interest that does not inhere in ordinary private business.

This factual and legal status is the reason for regulation. The purpose is to keep the private agencies directed toward their public function of furnishing proper service at reasonable rates, but at the same time to protect the private rights; equally to prevent exploitation and confiscation. The problem has been throughout to determine and maintain the relative public and private rights. Under the general standards that have prevailed reasonable rates have been fixed so as to furnish sufficient operating revenues to cover (1) ordinary operating expenses for labor and materials, (2) currently accruing depreciation, (3) taxes, and (4) a fair return on investment. Items (1) and (3), ordinary operat-

ing expenses and taxes, have normally been taken, with little dispute, from the accounting records, although the federal income and excess profits tax now raises special economic and legal issues.⁽⁴⁾ However, items (2) and (4), the amounts for current depreciation and for return on investment, have caused the chief regulatory troubles. They have not been subjected to regular accounting measurements and control, and they are primarily involved in the NARUC and FPC accounting provisions.

"Fair Value" Confusions

As to item 4, a fair return on investment involves two financial categories: (1) amount of investment, and (2) the rate of return applied to the amount. Both are basic and should be subject to exact factual control; but the first has been the chief cause of difficulties in the work of regulation.

The trouble has been in lack of clear concept and in non-factual standards and methods of determination. Instead of taking investment as such, which could be shown through accounting procedure, the Supreme Court, as already outlined, had prescribed the standard of "fair value" on which a fair rate of return must be allowed in the fixing of reasonable rates. This judicial prescription has been chiefly responsible for the prevalent non-functioning of regulation.

Fortunately, the indefinite, conjectural and litigious standards can now be replaced by precise definition of rights and by exact showing of facts. The new accounting applies both to item 4, the determination of investment on which a fair return must be allowed, and to item 2, currently developing depreciation.

Under the newly permitted legal definition, "fair value" can become

"prudent investment," which consists of the original cost of the properties used in service, less their depreciation. After initial readjustment of the accounts in regard to original cost and depreciation, the plant accounts are charged regularly or debited with the cost of new plant installations, and credited with the cost of plant items retired, so that their balances at any time show, as exact amounts, the original cost of the properties then devoted to public use. The depreciation to be deducted from the original cost is shown by the reserve. After its initial adjustment, it is regularly tied in with item 2, the amounts of currently accruing depreciation included along with ordinary operating expenses. The current charges to operation cover both the physical and functional causes of developing depreciation, and the amounts are simultaneously added or credited to the reserve; this is then charged or debited with the original cost of plant units retired (less salvage); it shows at any time the total depreciation of all the properties in service, in accordance with past provisions charged against operation.

Exact Accounting Provisions

Depreciation is thus definitely accounted for both as an element of current operating expenses and as a factor of investment determination. The provisions assure exact protection of the private investments through the rates paid by consumers. They do not, and cannot, impair, reduce or confiscate private investments, nor obscure or increase them. While they are designed primarily to facilitate the administration of rate control, and so to protect the public interest, they serve simultaneously to establish and maintain beyond impairment the private invest-

⁽⁴⁾ See "Relation of the War Taxes to Utility Rate Making," by John Bauer, *Public Utilities Fortnightly*, February 17, 1944.

The Functions of Public Utility Depreciation Accounting

ments on which a fair return must be allowed.

In the past the commissions have not had adequate legal powers to require comprehensive and systematic depreciation accounting in relation to the total rate making processes. The companies were virtually free to make such annual charges to operating expenses and to accumulate such reserves as they themselves decided, regardless of the allowance for depreciation in the fixing of rates. The rate making processes have not been harmonized with the accounting. In the usual rate case, regardless of the actual accounting, the allowances for operating expenses have been adequate to cover both physical and functional depreciation, but the deduction of total depreciation for rate base purposes, being based upon physical inspection and mainly upon testimony presented on behalf of the company, has reflected at most only the physical depreciation and ignored the functional. Often this inconsistency was glaring; it was pointed out and emphasized many times, but normally was disregarded in the cumbersome proceedings.

Treatment of depreciation has been one of the prime indefinitenesses and causes of dispute in rate cases. Many commissioners and students of economic policy, also judges, have long realized that it should be subjected to definite accounting, along with all the facts that enter into the fixing of reasonable rates. To the extent that they can be ascertained as exact sums through the accounts, regulation can be administered, without incurring conflicts of interest between investors and consumers. To the extent that they remain unclear, not continuously determined through the accounts, they are inevitably subject to dispute and make regulation non-administrable. Rates thus fixed are

almost bound to be unfair to the investors or to the consumers,—usually to the latter.

The objective in the reconstruction of regulation has been to replace uncertainty with definiteness of fact as required for manageable administration. Instead of leaving the provisions for depreciation to each individual company, the standards and procedures are, or should be, definitely fixed by the accounting classification under commission control. To determine the annual charges and credits, the so-called straight-line method has obtained extensive regulatory approval. It provides that original cost of plant units in service shall be charged off, or allocated, to operating expenses in equal annual amounts during the total lifetime of their economic serviceability. On the average when the economic usefulness of a plant item has expired, its total original cost (less salvage) has been included in operating expenses and paid for by the consumers. Depreciation is thus treated as a definite regular cost just as are labor and materials used for operation and maintenance. It constitutes an integral part in the over-all accounting for costs that enter into the fixing of rates, and it protects the private investments as well as the public rights.

Estimates and Accuracy

It is, of course, true that the regular provisions for depreciation depend upon estimates in regard to expected economic service lives. However, when for any year an exact amount has been derived for the depreciation that has taken place, the charges to operating expenses and the credits to the reserve are definite and should be binding in regard to the showing of relative rights.

The estimates naturally are, or should be, subject to revision as expectations prove to be out of line

with developing realities. Depreciation rates once adopted should be kept under continuous managerial and regulatory scrutiny, and they should be revised as factually warranted. With such scrutiny and adjustment, the charges to operating expenses and the credits to the reserve can be kept close to the underlying facts of physical and functional decline, and the accounting entries can be taken as decisive for rate making.

While the "accounted-for-depreciation"—Dr. Dorau's terms—should be as close as possible to the "depreciation-in-fact," the correlation inevitably involves estimates; there could always be substantial differences in individual judgments honestly and intelligently made. Since estimates cannot be avoided, I submit that they can be made more accurately in successive accounting periods than after long intervals, when rate case determinations are involved. With regular estimates, year by year, adjustments are feasible as warranted, and all the time the "accounted-for-depreciation" will also be, or should be, the recognized "depreciation-in-fact." If such regularity of factual determination is not maintained, then special rate investigation inevitably creates conflicts of interest both in regard to the proper annual depreciation provisions, and the total depreciation to be deducted for rate base purposes, and the findings can be far from the realities.

With this summary of conditions and regulatory objectives, I submit that there is nothing radical in the recommended and required depreciation provisions, and that they do not shift from recognized depreciation accounting to amortization or liquidation reserves. Their purpose is simple, to show currently the depreciation that is taking place as determined by best managerial and regulatory judgment, and correspondingly

to show the total depreciation that has taken place in regard to the properties left in service,—to protect equally the public and private interests, and not by indirection to diminish or confiscate private investments on which fair returns should be paid by the consumers.

The Nature of the Reserve

This view of the NARUC and FPC depreciation accounting was apparently misapprehended by Dr. Dorau. His discussion of the assumed accounting fallacies pursues two conceptions which, I believe, are erroneously imputed as alternative explanations on the part of the depreciation proponents (p. 4): (1) that the depreciation reserve is deductible from the original cost of plant in service "because it reflects the return of capital to the investors;" and (2) that it is deductible "in its own right, and without regard to 'actual accrued depreciation' because it reflects assets contributed by consumers to the enterprise, assets on which no class of investors has a right to earn any return." I submit that, in the light of the foregoing analysis, neither explanation is valid. The reserve does not reflect, and is not intended to, any return of capital to the investors. Nor does it represent capital contributed by consumers. It shows this and nothing else: the total depreciation that has accrued through past charges to operating expenses in regard to the properties in service.

It is true that the consumers, through rates paid for service, make regular contributions to cover the accruing depreciation. But these contributions do not constitute a return of capital to the investors. Like corresponding provisions for labor and materials charged to operating expenses, they are reimbursements to the company for costs incurred through the depreciation that

has taken place; they prevent impairment of capital, and preserve fully the private investments. They regularly make good and offset the accruing depreciation, as brought about by the accounting procedure. As funds they appear first in cash retained by the company from consumer revenues; then the cash may be spent for new plant items or for other corporate purposes. However, the funds thus locked within the business are altogether different from the reserve that is accumulated to reflect total depreciation at any given time. The funds are assets retained directly to replace the accruing depreciation. The reserve is an offset to the plant assets, showing their total depreciation that has been charged to past operation. It reflects the extent of the past protection that has been provided by consumers for private capital, not a return of capital to the investors or an investment of capital by the consumers.

Apart from the significance of the reserve, Dr. Dorau appears also to fear excessive accruals. He points to the possibility of 45 per cent ratio of reserve to plant costs, and assumes confiscation if such a reserve is deducted from the plant account balance. But, if the accruals are based on past charges to operating expenses for depreciation and have been duly covered by rates paid by consumers, and if the properties have been static for years and include considerable old and obsolete plant units, where is there anything unreasonable in a consequent 45 per cent reserve? And how could there be confiscation in the deduction from the plant costs? The balance would be the net unimpaired investment in the properties, provided that the accruals have been predicated sensibly upon the forces of depreciation.

The difference between Dr. Dorau and the analysis just presented is

well illustrated by one of his examples intended to show unfair treatment of investors. Under the theory that the reserve represents capital contribution by consumers, he assumes a company with a total plant cost of \$1,800,000 covered by bonds and stock \$1,000,000 and a reserve \$800,000 regarded as consumers' investment. Then he assumes an "act of God" which destroys half of the properties, with an original cost of \$900,000, roughly \$500,000 private and \$400,000 consumer investment; the latter amount is charged off to the reserve. The company is then required to raise \$900,000 to restore the necessary operation, or more if the plant costs are higher than the original cost of the destroyed properties, and, because of the assumed accounting implications, it would not be able to get an adequate return on the total funds devoted to the business.

Accounting Realities

I hold that Dr. Dorau is wrong in his analysis of what is involved. Naturally losses due to catastrophies require special consideration according to the circumstances, but they must be paid for, and the cost is properly placed upon the consumers.

The plant destruction and losses would have to be analyzed and determined, under commission control. To an appropriate extent they would be charged to the depreciation reserve, so that the balance would reflect the depreciation of the undestroyed plant. The rest, under the FPC classification, would be charged to a balance sheet debit suspense, Account 141, Extraordinary Property Losses, and would be written off to Account 506, Property Losses Chargeable to Operations, as approved by the Commission. These charges would in fact constitute amortization and not depreciation, but they would be borne as exact amounts by the consumers through the rates paid

for service. The cost of reconstruction would be charged to the plant accounts, and the amounts would then be subject to regular depreciation accounting. If the amortization could not be covered by existing rates, adequate increase could promptly be obtained, without involving factual disputes and prolonged proceedings.

The analysis as thus presented represents on the whole rather simple accounting categories which should be clear to accountants and others who understand balance sheets and income statements. That both the plant and depreciation accounting can be subjected to definite standards and exact accounting should arouse no misapprehension or disagreement. Nor should there be misunderstanding in regard to the bearing of the annual depreciation provisions and reserve upon the assets correspondingly locked within a company's capital structure. In the case of expanding properties, and such are almost all electric companies, the immediate cash reimbursement by consumers to offset accruing depreciation are usually best spent in new plant expenditures; and for accounting purposes, or otherwise financially there is no distinction between plant replacements and additions. However, in instances of static or recessive properties, the total cash accumulations are normally not needed for new plant purposes, and they can be devoted to any one or a combination of the following corporate uses:

First, investment in securities to contribute to the corporate income.

Second, retirement of corporate debt.

Third, acquisition and retirement of preferred stock.

Fourth, acquisition and cancellation of common stock.

Fifth, reduction of capital stock investment by direct prorata cash reimbursements.

Whichever of these methods of cash utilization may be employed, it does not affect the depreciation that has taken place and accounted for. Nor can it impair the financial status of the security holders, or affect the relative rights of the consumers and investors. I submit to accountants and to economists that public utility accounts can be so constituted and controlled that they will present definitely all costs and charges, including those of property depreciation, for fixing reasonable rates. This is what the FPC classification and the NARUC recommendations set out to do.

With exact factual showing, regulation can be made a matter of systematic administration in regard to total public and private rights. Rates can be promptly reduced or increased with equal protection of investors and consumers. The failure of past regulation has been due to indefiniteness of standards and to unreliability of the facts on which findings were based. These uncertainties can now be removed, and regulation can be made manageable, if suitable and available accounts and other records are duly provided.

Notes on Deductions for Bad Debts under Federal Income Tax Law

By DONALD HORNE

AN aberrant suggestion has recently been made that the reserve method of deducting bad debts can be imposed upon taxpayers. The suggestion goes even further—that the reserve method can be imposed with respect to part of the bad debts, or those of a department of a business, leaving other bad debts to be reported on the specific basis. The theory advanced is that such requirement may be justified as clearly reflecting income.

The suggestion is, to say the least, revolutionary. The justification put forward is questionable. Previously, the use of the reserve method has been considered a statutory privilege accorded to taxpayers. It has never been regarded as a duty, or as capable of being transmuted into a duty—with one exception. A taxpayer who has voluntarily adopted the reserve method must use it consistently from year to year, unless and until he obtains permission from the Commissioner of Internal Revenue to change back to the specific bad debt method. But it is clear that the permission so applied for cannot properly be refused, as hereinafter shown. The election to use the reserve method requires approval, and here a real act of discretion is involved. But to change back to the specific method would seem to require nothing more than notice, and the offer to make proper adjustments to prevent the escape of income from taxation.

The privilege of using the reserve method is alternative. The statute requires either the specific method or the reserve method. There is no provision for a combination of both.

The reserve method serves a very

useful purpose, and is availed of by many taxpayers, particularly corporations, having sufficient volumes of steady business to acquire reliable statistics upon which to construct reserves. It is, however, capable of being misused, and it is doubtful whether any taxpayer would want to be bound to use it without recourse to the specific method, if the reserve method operated unjustly. The right to return to the specific method is a check against arbitrary treatment under the reserve method.

But can the use of the reserve method ever result in tax injustice? Does it not merely allocate an average to each taxable year, based upon experience, where the specific method might result in excessive losses for some years, insufficient losses in other years? In theory, this should be so; but actually, the reserve method, unless it can be abandoned by the taxpayer at will, may be an instrument of excessive taxation.

In particular, the provision for the reserve method, as it has been construed, may deprive a taxpayer using the reserve method, of the relief of "recovery exclusion". This relief springs from legislative recognition that taxation of recoveries of bad debts is taxation of capital as income, especially where the recoveries are of deductions that had no effect on taxes.

The Commissioner holds that the recovery exclusion provisions of the Revenue Act of 1942 do not apply to a taxpayer on the reserve method. In so ruling, he followed the Congressional committee reports (House Report No. 2333 on the Revenue Bill of 1942—H.R. 7378, page 70; Senate Report No. 1631, on same

Bill, page 80). The same language was used in both reports, and read:

"The amendments made by this subsection do not apply to recoveries on account of bad debts previously charged or chargeable against a reserve, by a taxpayer on the reserve method of treating bad debts, inasmuch as the amount of such recoveries is not taken into income as such but is merely credited to the reserve account and decreases the amount of the addition to the reserve which has previously been taken as a deduction in lieu of a deduction for specific bad-debt items."

It is not pertinent to discuss the correctness of this quoted statement at this time. The statement is correct in the same sense that the schoolboy answered correctly when asked why Washington crossed the Delaware. His answer was, "I don't know". The above statement is correct in that it is a true copy of what the Congressional Committees said.

The "recovery exclusion" provisions do not expressly provide any relief for taxpayers on the reserve for bad debts method, although it is said that a deduction which availed the taxpayer no tax benefit "decreases the amount of the addition to the reserve", and thus results indirectly in taxation of some amount of capital recovery. The amendment is not necessarily unconstitutional because of the omission to provide for taxpayers on the reserve method, because it is purely curative and declaratory of the law as it previously existed, and has no effect to tax capital which, under the previous law, properly construed, was exempt on principle. The Supreme Court, in *Dobson v. U. S.*, 320 U. S. 489, remarked that the amendment was merely declaratory, and that no negative implication was to be drawn from it.

The feature pertinent to this discussion is that, in practice, as the law is now construed, taxpayers using the reserve method are given no relief from taxation due to recoveries of amounts previously deducted without tax benefit. In other words, they are being taxed where there was no economic gain to tax, contrary to principles announced in the *Dobson* case, above cited. The question is, since taxpayers on the reserve method are thus unfairly discriminated against, can they be prevented from departing from the reserve method and coming into the fold where they would be protected by the amendment?

The answer to this question depends upon analysis and interpretation of the statutory provisions. The question is one of proper accounting; but the solution depends upon the answer to a question of law, which is, what does the statute permit and require.

The pertinent words of the statute involved (Sec: 23(k)), Internal Revenue Code, are:

"In computing net income there shall be allowed as deductions: * * * Debts which become worthless within the taxable year; or (in the discretion of the Commissioner, a reasonable addition to a reserve for bad debts) * * *."

Even a casual perusal of these words shows that the discretion of the Commissioner is confined to whether the taxpayer may use the reserve method. The statute confers upon the Commissioner no authority to deny the use of the specific bad debt method. The explicit grant of discretion with respect to the reserve method is a denial of discretion with respect to the specific bad debt method, under the universal rule that the inclusion of one power alone, excludes all others.

The reasons for confining the discretion to the reserve method are

clear. The basic method prescribed is the specific bad debt method. Until 1921, it was the only method provided for. The privilege of using the reserve method is an exception to the general rule. The reserve method is an alternative, which the Commissioner may, but need not permit.

For example, assume the case of a taxpayer, in existence as such since 1913, who never suffered a bad debt loss until 1944. He could undoubtedly deduct the amount of the bad debts in his income tax return, without consulting the Commissioner. The deductions could not be disallowed on the ground that he should have used the reserve method. But suppose he desired to set up a reserve method instead. He could not deduct an addition thereto, in lieu of the actual amount of the bad debts, without applying for and obtaining permission of the Commissioner.

A further reason why the Commissioner's discretion does not relate to the specific bad debt method is that the latter fits any case. That is why it is the basic, or primary method. But the reserve method might be entirely inappropriate. In the example stated, the taxpayer would have no statistical data upon which to determine a reasonable reserve, and insufficient data upon which to determine what would be a reasonable addition to the reserve in any subsequent year of the near future. Exercise of the Commissioner's discretion in such a case would not only be appropriate, but necessary.

Undoubtedly, the discretion conferred on the Commissioner relates only to the use of the reserve method.

Well, then, what of the theory that the reserve method can be required, as more clearly reflecting income?

The facts, in general, do not support this theory. Who can say that the reserve method more clearly reflects income? It is, in every case,

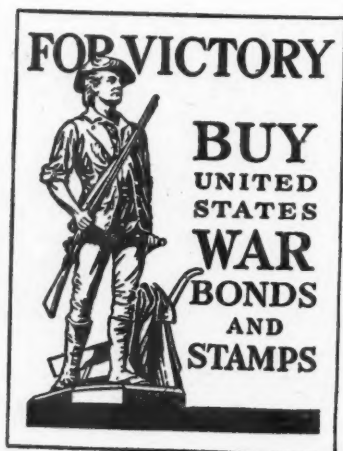
based upon an estimate of losses not yet sustained. If the estimate is too high or low, the fact may not be ascertainable for several years. The practice is then to reduce the additions to reserve for subsequent years. Such deduction does not correct the net income for the years when the bad debt deduction was too high or too low, but merely provides an offset in subsequent years, which may distort the incomes for those years. The specific bad debt method has the advantage of being exact. Instead of the reserve method more clearly reflecting income, it is permitted by special statutory dispensation although, by reason of its very nature, it is incapable of accurately reflecting income.

The use of the specific bad debt method is a matter of fundamental right. It serves to eliminate from taxable income capital recovery in the form of income items, which is necessary because income cannot, by its nature, come into existence until losses of capital investments are made up. The use of the reserve method as a substitute for the specific bad debt method is a privilege, which the taxpayer need not elect, and if he does, which requires the approval of the Commissioner. The taxpayer cannot have the reserve method imposed upon him, because it may not operate to remove capital items from his taxable income. The Commissioner may disapprove it, because it may not be appropriate or workable, and because the statute expressly so provides.

The theory that the Commissioner is authorized to require the use of the reserve method with respect to some classes of bad debts, or some departments of a business, falls with the idea that the Commissioner can require the reserve method at all. The Commissioner cannot properly approve the reserve method as to part of the bad debts. The statute

does not make any provision for a half-way election. It is in the alternative, and requires either the specific bad debt method or the reserve

method, not a mixture of the two. In order to qualify for the reserve method, a taxpayer must completely abandon the specific bad debt method.



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Measurement in Accounting

By ROY B. KESTER, C.P.A.

The Problem of Measurement

WHEN any transaction is recorded on the books, the quantitative measurement of it is expressed in the common monetary unit, the dollar. Its effect on the three basic elements, assets, liabilities, and proprietorship, is measured and recorded in terms of dollar amounts. The problem of measurement, however, has two aspects which must always be kept in view, viz.:

1. The proper dollar measurement at time of record.
2. The proper principles to be observed for subsequent re-measurements.

It has been suggested that accounting is only a recording function—i.e., it simply makes an historical record. If that is true, accounting is concerned only with the first aspect of the measurement problem, viz., that of determining and recording the dollar measurement at the time of record. Inasmuch, however, as balance sheets must be drafted periodically and these must always reflect the record at the balance sheet dates, accounting is forced to consider the problem of periodic remeasurement. The admission of an item to the balance sheet does not forever hold that item to its amount at the time of record, as such amount may not at all express the financial and income status at a subsequent date. Day by day in any business, assets are being acquired and measured for purposes of initial record. At the close of the fiscal period all of these different assets must be restated to measure the portions, if any, consumed in the income operations of the current period and the portions thereof carried over

to serve future periods. It thus becomes necessary to consider the second aspect of the measurement problem, viz., that of remeasurement.

Importance of Measurement

The problems of content and measurement strike at the very heart of the balance sheet. Form, framework, and method of presentation are important and their usefulness should not be esteemed lightly. Particularly is this seen to be true from the standpoint of availability of the information presented and of facility in its interpretation; but the meat of the balance sheet is its content—items and amounts. In this connection two points always demand consideration, viz.:

1. What items shall be admitted to a place in the balance sheet.
2. On what basis shall they be admitted, this latter being the problem of measurement.

As stated above, the second question is twofold, viz.: (1) what shall be the basis of measurement when an item is first acquired and entered on the records; and (2) what principles shall be observed for its subsequent remeasurements.

The significance of the measurement problem is apparent when the purpose and uses of the balance sheet are considered. Regardless of what the items are which are given a place in the balance sheet; regardless of the care employed in the selection of titles to render their meaning clear and unmistakable; and regardless of how correctly those items may be classified, grouped, and marshalled, it is their measured amounts which give them their real significance when

used to show financial position. Financial position, as such, is not expressed on the face of the balance sheet in generally understood units of measure; it is the result of human judgment based upon the data there shown—it is the result of an interpretative process. It is, therefore, of primary importance that the question of measurement be examined and attempt made to formulate its controlling principles.

Measurement and Value

To measure anything is to determine its quantitative amount in terms of a unit. There are different units of measure, depending upon the kind of information as to quantity desired. Thus there are units of weight, size, money, energy, etc. In the formal book records accounting is concerned primarily with the money units; most of the information furnished by the books is in terms of dollar amounts, and the dollar is the common denominator of business transactions. The value of anything is its worth in exchange or in use at a given time and is determined normally by the acts of buyers and sellers. It, too, is expressed in dollars. The word is used with various shades of meaning, indicated by such qualifying adjectives as, e.g., cost value, sales value, liquidation value, going concern value, etc. Since, however, the word is always tinged with the idea of worth—i.e., sales value—and measurements of the same item may for different purposes result in different amounts of dollars, accounting terminology needs a word or phrase dissociated from the connotation of worth. For this purpose the words, dollar amount and measurement, will be used here. The word measurement carries no implication of present worth but merely the dollar amount of an item as measured for the accounting records and the basic reports.

Amounts Received and Expended, the Basis for Accounting Measurements

From the time of organization of a business unit throughout its operating life, funds or properties come into it from owners, from creditors, from sales of product, or from other sources—all stated in terms of their dollar amounts. That is, cash—the legal tender money of the country of domicile—or its equivalent is the basis for all such transactions and the dollar amounts involved measure the original effect of the transactions in the accounting records. These amounts are usually stated in the transaction contract—express or implied—or are determinable from it. The cost, i.e., the amount expended in purchase of properties or services or for other purposes, such as the payment of debt, is stated in terms of cash or its equivalent and so provides the measure of these transactions for entry on the books of account. Thus, usually, all business transactions are consummated and the amounts involved are measured in terms of cash or cash-equivalent. Since a primary need of management is information as to the status of invested funds—expressed in terms of cash or cash-equivalent—the accounting record to be made of all transactions, if it is to be a factual record, must of necessity be in the same terms and measures.

The dollar amount of the item content of the records at time of first entry of the item is, therefore, quite easily determined in most cases. As to properties, services, and other purchases, their dollar measurement is their cost; as to proprietary items—capital or income—and other sources of funds, their dollar measurement is the cash or cash-equivalent amount invested or received. Only so can trustworthy information be provided as to integrity of invested capital.

The Measurement of Cost

In a commonly accepted sense, the cost price to the purchaser is the seller's sale price and this is, therefore, easy of determination. However, when the term is applied to the purchaser's assets, cost means something more than the purchase price; it includes all of those supplementary or additional costs which must be incurred in connection with the asset in order to place it where it is to be used in a given concern. Thus, the cost of merchandise is not merely its invoice cost but includes as well all inward transportation costs and all costs of handling to place it in position ready for sale. The determination of the full cost of individual units of merchandise is oftentimes very difficult, for many of these supplementary costs are incurred jointly with other units and no logical practical basis can be found for distributing them among the several units benefited. In the case of manufactured product, the problem is much more complex. While it is possible, by means of a proper classification of accounts, to segregate all manufacturing costs—i.e., raw materials, direct labor, and overhead—from other costs, it is at times a very complicated problem to distribute each of these costs equitably over the different kinds of product turned out.

Similarly, the cost of fixed assets includes invoice costs, transportation costs, and placement costs—the cost of all of those services and supplies necessary to place the asset in position to function as a part of the operating mechanism of the concern. In the case of intangible assets, cost presents many problems. Thus, organization expenses constitute an asset and must be given place on the balance sheet. Such an asset comprises those costs or expenditures incurred to effect the organization of the business and get it under way. Many questions arise in connection

with this and other assets. Thus, in addition to the usual content of this asset, should its cost also include underwriting costs and discounts on the sale of stock necessary to finance the business? To what asset does the discount belong when bonds are sold for less than their face value? When large expenditures are made to secure the patronage and goodwill of the public, how much, if any, of these costs are asset costs in connection with the asset goodwill? When a plant is being constructed, may all costs incurred be applied as costs of plant—i.e., may interest on borrowed funds used, may taxes paid, may costs occasioned by mistakes of judgment, all be considered as costs of plant? These and many similar questions call for answer in the determination of the proper measure of cost.

The relation of the paying or cost medium must also claim attention in connection with cost. Where the measurement of the cost incurred is in terms of cash, determination of its amount is easy. Where payment of it is made either in services or in the company's own securities, as its stocks or bonds, the true measure of the cost is not so clear. All of these questions are mentioned here only to point out some of the difficulties of cost determination.

The Individualistic Character of Cost

From the viewpoint of accounting, determination of cost is usually an individual matter, i.e., it is a matter that has reference always to the individual business unit. An illustration will make the point clear. If two business concerns build identical plant buildings, the one accepting a contractor's bid therefor of \$500,000, the other letting the contract to another builder at a bid of \$550,000, to the one concern the cost of its plant is \$500,000 and it will so record it; while to the other its plant

will be recorded at a cost of \$550,000, even though it is identical in all respects with the first plant building. Thus, there may sometimes exist the rather peculiar situation in which virtually identical assets, acquired at the same time, will have different costs. In business there is no such thing as absolute cost; cost is an individual matter. The records of an individual concern must show what its own costs are; never those of a competitor, nor what its own costs might have been had other conditions prevailed or other decisions been made than those which were made. In other words, the records of each concern must provide an accurate history of what actually took place in that concern. It is essential in a study of accounting measurement to bear in mind the individualistic character of cost.

To differentiate between the generally accepted basis for account measurement at time of record—i.e., the amounts received and expended—and other bases suitable for special purposes, it is desirable to examine some of these purposes before treating the problem involved in the usual periodic remeasurements of recorded items.

Special Purpose Measurements

There are several kinds of special purpose measurements, all more or less closely related to commercial balance sheet measurements but differing from them in some respects because of their differing purposes. Among these may be mentioned the following measurements: (1) for purposes of fire loss adjustment; (2) for purposes of liquidation to satisfy creditors and determine the owners' equities, as in bankruptcy and voluntary dissolutions; (3) for purposes of taxation; and (4) for purposes of sale and purchase of a business unit. In all of these cases many points of similarity to, and of some differences from, our present problem are found.

In the first case, current price levels form the basis of measurement. In the second case, the problem may be entirely different, as dollar amounts often have to be determined on the basis of forced sale. In the third case, many different measurements and bases are used, depending on the kind of tax and the practice of the local taxing authority. In the fourth case, the prevalent conditions determine the basis. Thus, it may be necessary to recondition the plant purchased to make it serviceable for its new use; or the larger control of the market effected by means of this purchase may make the plant much more valuable than its physical worth. Elements of established markets and goodwill call for measurement in the case of a purchase and sale transaction but are usually not present in commercial balance sheet measurements. These last questions touch closely on our problem.

Among the more important kinds of bases used for these and other special purpose measurements are:

1. Cost
2. Market—wholesale and retail
3. Reproduction cost
4. Scrap, salvage, junk, or . break-up
5. Service
6. Present or depreciated
7. Sound
8. Fair
9. Tangible or physical
10. Intangible
11. Taxable
12. Earnings—capitalized
13. Liquidation or forced sale

These various kinds of dollar measurements of assets are construed loosely in most cases, but have quite technical connotations in some places. Any of the terms employed here will, whenever necessary, be defined.

Source of Data as to Measurement Bases

There are many sources of data as to the above bases. Where double-entry books are kept, the original cost of the various assets can usually be secured from the books of account. If not found in the financial record (as is often the case where single-entry books are kept), the original purchase invoice gives the chief item of cost, but does not usually show any inward-carrying or placement costs. Where there is a formally established market, this may give the information as to value when no book entries are available. Quoted prices in trade catalogs or lists as of the date of purchase, offer another means of procuring the information. Occasionally, even the memory must be relied upon.

Again, where it is desirable to approximate the dollar measure of the earning capacity of a business by capitalizing its earnings, the statement of earnings becomes the basis, even though earnings themselves contain many elements which rest on estimated amounts.

Thus, in the determination of many kinds of measurements there is an element of speculation—an estimate based on human judgment.

Going-Concern the Basis for Periodic Remeasurement of Items

While the measurement of balance sheet items at the time of their first record is comparatively simple, their remeasurement at successive fiscal periods involves other considerations which grow out of the concept of a continuous operation of the business. This may be described as the going concern basis of measurement. This use of the term must not be confused with its use in connection with the valuation of public utilities where it usually refers to those intangible values which have accrued from expenditures made to put the concern in good

operating condition. The term as used here will have reference to the amounts at which the various asset, liability, and proprietorship items should be carried when viewed from the standpoint of a concern which expects to continue operations—a going concern as contrasted with one which is facing dissolution, reorganization, sale, or other eventuality. Thus, going concern measurement is not so much a distinct type of measurement as it is a term descriptive of the kinds of dollar measurements suitable for a going business.

As previously pointed out, the kinds of measure to be used depend upon the purposes to be served. The four-fold general purpose of a balance sheet has been stated as being that of supplying a common core of appropriate information to the four parties at interest, viz.: (1) management, (2) creditors, (3) owners, and (4) the public. Management must be furnished with such information as will enable it to carry out its two basic obligations, viz.: (1) the maintenance of the integrity of all funds—owned or borrowed, and (2) the earning of a fair average return on such funds. It thus needs continuous or periodic information as to the amounts, maturities, and other contractual conditions of borrowed funds, the status of proprietary investments as to kinds and amounts, the status of income operations, and the kinds, amounts, and condition of the properties used in the operation of the business. Creditors, both short and long-term, need information as to the security back of their loans, the ability of the company to pay both principal and interest, the progress status of the business, and such other data as are pertinent to the terms of their loans. Public authorities, so far as they can be served by the standard periodic reports of a business unit, are primarily interested in its income opera-

tions and the gross and net properties used in the conduct of the business.

From the standpoint of a going concern, therefore, the content of a balance sheet must be so measured in dollar amounts as to show:

1. Its debt-paying ability—its solvency,
2. Its solidity—its fixed capital status,
3. Its progress as to income operations, and
4. The status of the owners' investment.

Accordingly, these four items of information must be remeasured periodically on the assumption that the business unit expects to continue operations over the years ahead. The prudent optimism of keeping going, rather than the pessimism of business failure, is the mental attitude to be observed in making these periodic remeasurements of balance sheet items.

Measuring the Assets

As indicated previously, the two aspects of the problem of measuring the assets are: (1) what dollar amounts are proper at the time of original record; and (2) shall the same or other amounts prevail at subsequent intervals when results are to be summarized formally? As to the first question, the basis of the original measurements made at time of formal record has been previously stated as the cash or cash-equivalent dollar amount of the properties invested and of those purchased, i.e., the full cost of those purchased. The answer to the second question was given in general terms in the paragraph next above. While there are several considerations involved, as there indicated, the proper measurements of income operations and of solvency are the most important and are therefore usually control-

ling. Under the going concern basis the portions of the measured amounts of assets which have been used up, expended, or lost in the current period's operations must be shown as costs of operation and only the portions which may equitably be allocated to the costs of future operations be carried forward as asset items at the end of the current period.

Conflict of Measurement Bases

While other factors are important and may never be disregarded, the two factors mentioned above—solvency or debt-paying ability and progress or the earning power of a business—are so fundamental from the standpoint of a going concern as to be controlling. Solvency rests mainly in the current assets. This function of the current assets dictates the principles of their measurement, viz., on the basis of their debt-paying ability, i.e., their prudently determined cash realizable amounts. This is so fundamental as to take precedence over all other considerations; the ability to pay debts is a prerequisite to continuance as a going concern.

Of almost equal importance is the second factor, the earning power of the business. Earning power is the primary basis for determining the worth of a business—information in which every owner and prospective investor is interested. It is the main source of the supply of funds which regularly flow into the business to maintain its working capital. From a long-term point of view it is, therefore, an important element of solvency; for debts must be paid out of working capital. At a given time, however, solvency must be determined without reference to earning power. Hence the immediate interest of the short-term creditor group is in solvency, whereas that of the owner group is in earnings. The chief point of contact

between the interest as to solvency and that as to earnings is in the measurement of the current asset, inventory. A conservative—i.e., generally prudent—measurement of inventory provides a sounder basis for judging solvency than a higher one doubtful of realization; whereas the higher measurement brings about apparently better earnings which may provide the basis for higher dividends. Thus a conflict of interests between these two groups may easily arise and the predominant interest of one must never be allowed to influence the measurement of inventory to the detriment of the other.

The management group also is interested in the measurement of inventory. So far as possible, the accomplishments of management brought about by its own effort must be segregated from those brought about by external forces over which the management has little or no control. As a general principle, therefore, it is not desirable to bring into the record of internal results, either an unrealized profit or an unrealized loss, although the latter is usually less objectionable than the former. A statement of merchandise at any other figure than cost does bring into the record an apparently unrealized profit or loss. If, then, the cash realizable measure of merchandise differs from cost, there is obviously a conflict of measurement bases.

In connection with depreciation there may also sometimes seem to be a conflict of interest. The interest of the long-term creditor group, which may have accepted some of the fixed assets as collateral security for their loan, is at a given time tinged with the present value of the collateral—the measure of its debt-paying capacity—and is not wholly in its going concern measurement. In the latter basis of measurement,

however, lies the chief interest of the management group. Thus there may easily arise a conflict of interest between these two groups. The manner in which measurement is made of the expired portion of the fixed assets—chargeable to the current period's income—and the unexpired portion to be carried forward as costs of future periods, may easily favor the interest of one group or the other. Thus going concern measurement of fixed assets subject to depreciation must follow a middle ground which will favor neither group.

Measurement of Liability Items

Measurement of the liability items of the balance sheet is for the most part limited to a determination of their dollar amounts to be entered on the records and in the reports. The problem of the liability items is chiefly one of inclusion and careful classification as between current and fixed.

Although the measure of the liability items is usually determinable from the contracts giving rise to them, there are many instances in which that is not the case. Here, a real problem of measurement enters and must be solved, in most cases, by careful estimate in the light of circumstances, estimate being oftentimes based on past experience. Thus, if a company sells its product with a guaranty of quality, it is the common experience of sellers that some of these guaranties must be made good. The cost of such and the liability thereunder attach equitably to the period of sale. Consequently, the balance sheet of that period must reflect an estimated—measured—amount of the liability belonging to it. The same problem is met in connection with goods sold with a redeemable premium coupon or profit-sharing certificate. In the case of lawsuits pending against the

business, a similar, though more difficult, measurement problem is faced. Most of these measurement problems relate to current liabilities.

In connection with fixed liabilities, the question is sometimes raised as to whether the measure of these should be the gross amount to be redeemed at the agreed future time—usually the face or par amount—or the present worth amount, determined at each balance sheet date on an actuarial basis. The amount contracted to be paid at maturity is of such importance as to indicate that it should be shown as the significant amount. The related offset and adjunct items—the bond discount or premium—are in the nature of services purchased and are to be recognized in the records and the reports the better to show the effective rate of interest on the loan. An asset and liability remeasurement problem is involved here to determine the portions equitably to be charged over the periods to the maturity or retirement of the loan.

Measurement of Proprietorship

The proprietorship section of the balance sheet usually shows the owners' equities in the form of originally invested capital, i.e., paid-in capital, and additional capital secured by reinvestment of earnings or by gift. Both of these items should be carefully stated, for their amount is an item of great interest and importance to actual and prospective owners. It is apparent, of course, that if the assets and liabilities have been correctly measured, stated and fully shown, the total of owners' equities is thereby also correctly determined and stated. In the measurement of the assets and liabilities, it has been pointed out, the factors of solvency and earning power are the controlling considerations. Since the assets and services are measured by the amounts invested or expended therefore, stated

in terms of cash or its equivalent, it follows that the proprietorship section measures the amounts invested, either originally or subsequently through reinvestment—or withholding—of earnings or gifts. It should be emphasized that this section does not show the present value of owners' interests. For this purpose the record of earnings over a period of years is the usual basis. In the case of stocks listed on the exchanges current market quotations serve as the best indication of present values, reflecting the combined judgment of many who have attempted to weigh the various value factors, including both past and prospective earnings, and to arrive at a measure of their worth. Thus it is apparent that the purpose of the proprietorship section is to show owners' equities in terms of cash or equivalent amounts invested, withheld, or received as gifts, and never the present value of these equities.

Over- and Undervaluation

The need for correct measurements requires no comment and can best be appreciated when compared with the effects of over- and understatement. Particularly bad and harmful is overstatement of the assets and understatement of the liabilities. The use of the balance sheet as an index of financial position makes apparent the harm of wrongful content or measurement of the items entering into it.

The Balance Sheet as an Expression of Opinion

From what has been said it will be evident that measurement in the vast majority of cases is not an exact science—a process of definite determination. Rather, from the nature of the data to be handled and the principles of measurement given as applicable to the various groups of data, remeasurement must always

Measurement in Accounting

be somewhat of an estimate. The determination of the measured amounts of the several elements of cost, the proper differentiation between capital and revenue charges, and finally the calculation of the amount of depreciation necessary to the remeasurement of fixed assets—all are estimates. It is true, they are estimates based on experience, but from their nature and the influence of local conditions in a given case, no universally applicable law of

experience can be formulated. It is safe to say that two men would seldom, if ever, arrive at exactly the same estimate of the dollar amounts of given assets. Thus it is seen that a balance sheet is not a statement of fact but always an expression of opinion. If measurements are carefully made in the light of all available facts applicable thereto, the expression of opinion in the balance sheet will approximate as nearly as may be to a statement of fact.

If you can't go across—

COME ACROSS

BUY

**. UNITED STATES
WAR BONDS AND STAMPS**

Internal Audit Reports

By LAWRENCE R. SCHMIDT, C.P.A.

INTERNAL audit reports are one of the principal means by which management measures the efficiency of its operations and that of the Internal Audit Department.

These reports are not only important to the auditor who prepares them and management that receives them but should likewise be of interest to the public accountant and Government auditors as an indication of the adequacy of the company's system of internal control. Since the extent of verification to be made by these outside auditors will be determined by the system of internal control in effect they should use all available information in formulating their opinion as to the degree of control existing.

Unfortunately, however, internal audit reports are not as uniform as are the certificates issued by certified public accountants, instead, there are as many varieties of reports as there are brands of cigarettes. Some deal in generalities briefly outlining the scope of activities and presenting a general conclusion as to the reliability of the records; efficiency of employees, etc. while others go to the opposite extreme and detail all errors found and the extent of the various tests made.

Needless to say the latter type of report is of more value to the management that receives it than the former type and is likewise more helpful to the public accountant in appraising the system of internal control. The chief objection to such report is the amount of detail that has to be read in order to reach a conclusion. In attempting to scan through the voluminous contents, readers may very well skip over matters of importance.

The middle course would seem to be best, omitting all detail that is

not essential to a clear understanding of the conditions disclosed by the audit but including everything required for comprehension of the true state of affairs.

The lack of uniformity in internal audit reports is due to many reasons although the principal ones are as follows:

1. Reports are intended chiefly for management's use and they to a large degree dictate the form of presentation and extent of details to be included.
2. Internal auditors are not licensed, there are no professional standards to be complied with.
3. Nature of the industry—In some industries certain phases are of prime importance and these might be stressed. Special reports might even be prepared to cover these special phases.
4. Ability of internal auditor—Some internal auditors are good practical men with extensive experience but do not possess ability to write good reports. Most public accounting firms employ specialists who edit all reports.
5. Degree of care exercised in preparation—If management places little importance on audit reports issued, internal auditors are apt to acquire the same attitude.

Internal audit reports should reflect the same degree of care in their preparation as is exercised in performance of the audit verifications. Report writing is not easy even to persons with extensive experience. To prepare a clear, concise report requires considerable effort and distinguishing the essential items to be

Internal Audit Reports

commented on from the unessential, is likewise no small task.

Public accountants take precaution when infractions of accounting principles are noted, to protect themselves by going on record in their reports. Internal auditors should also follow this practice even though they know that management is aware of the condition and does not intend to change it. Unless the internal auditor takes this precaution, his failure to comment might later be construed as approval of the practice, thereby reflecting on his ability and integrity.

In spite of the special requirements that might influence form and content of the internal audit reports there are certain general rules that should be considered in report preparation as follows:

1. Reports should be concise but comprehensive.
2. Voluminous schedules and analysis should be avoided.
3. Not necessary to list details of all exceptions found, these can be supplied from workpapers if desired. However, all important findings, conclusions and recommendations for improvement of methods should be included.
4. All statements should be accurate and definitely supportable by information in working papers.
5. Arrangement of details in report should follow a consistent pattern. The customary method is to follow the order of the items in the balance sheet. Report should likewise be broken up with suitable headings to facilitate review and subsequent reference thereto.
6. Reports should not contain details as to the extent of audit tests, especially when audit was conducted in accordance with established audit program.

Most persons in the concern who receive copies of the report are not qualified to judge sufficiency of the audit scope. Public accountants and Government auditors interested in the extent of internal audit activities can determine this from review of the audit program.

7. Criticism of existing practices must be supported by constructive recommendations.
8. If urgency requires issuance of special report of certain findings, reference thereto should be included in the periodic audit report issued.
9. Comments should be presented in an impartial, impersonal manner.
10. Reports should be issued promptly upon completion of the audits, otherwise comments will lose effectiveness.

It is a generally accepted practice to review audit findings with the supervisor of the department concerned. Although auditors are not to give instructions to employees they are often able by tactful suggestions during these reviews to immediately effect correction of some of the deficiencies noted in their audit.

Since the errors have been rectified the auditor may question propriety of including the matter in the audit report. The determining factor is the proportion and nature of the discrepancy. Generally where exceptions warrant inclusion in reports if not corrected, they still merit mention, since the supervisor who corrected the conditions may have taken this action merely to preclude reporting of the item.

There is always the possibility that supervisors may revert to their old methods as soon as the auditor's back is turned and the situation continues undetected until the next periodic audit. Existence of such

errors might very well be an indication of laxity of supervision, about which management should be informed.

Unfortunately many of the officials, to whom audit reports are addressed, are so burdened with other duties that considerable time elapses before attention is given to errors reported, or to rectifying the conditions that made them possible. Major discrepancies that will increase in proportion as time elapses, should be specifically mentioned for immediate attention, in the transmittal letter which accompanies the audit report.

Unless management follows up audit report comments and recommendations, they will not be deriving full benefit from their internal auditing. Moreover, nothing stifles internal auditor's interest and incentive more than disregard of the reports they issue.

Recognizing the fact that the executives who receive internal audit reports are busy men, the auditor should try to the best of his ability, to make it easy for such individuals to read his reports, and to take corrective action.

One method employed by internal auditors with some success, is to prepare excerpts of the various sections of the audit report, to be submitted to the supervisors of the departments concerned, with recommendations for improvement. These are accompanied by form transmittal letters, to be signed by the reviewing executive, which requests that the recipient investigate the exceptions taken, consider appropriateness of the suggested changes, and advise the transmitting officer of their findings and disposition of the audit comments.

The reviewing executive can thereby begin action on the audit findings, by simply signing and releasing the transmittal letter and related audit report excerpt.

An instance is known where a general manager who had been receiving audit reports every month for a year, which were filed without being read, out of curiosity, happened to look at one. It held his attention and when he had completed reading it, was so enthused, that he started to inquire as to the whereabouts of the previous reports and the action taken to correct the situations reported.

Of course, the auditor cannot make management read his reports, but he should try to prepare them in such a manner that when executives like the general manager find time to read them, they will be stirred to action. Long involved reports crowded with minor exceptions, details of audit tests and dealing in personalities will not have the desired effect.

In view of the increased emphasis placed on internal auditing, of late, general improvement in quality of internal audit reports can be anticipated. While some internal auditors can still be classified as glorified bookkeepers, many internal audit staffs are now composed of former public accountants, many of whom are certified men. Even the junior auditors of many staffs are college graduates who majored in accounting. This improvement in caliber of audit department personnel should be reflected in the audit reports issued.

Moreover, the activity of the Institute of Internal Auditors in conducting discussions on the subject of audit reports and disseminating information thereon, should likewise contribute toward general advancement and greater uniformity.

The public accounting profession can likewise aid in this development to a considerable degree, since managements and their internal audit staffs are receptive to recommendations offered by their public accountants.

Income-Tax Returns and the Practice of Law

The National Conference of Lawyers and Certified Public Accountants, consisting of five representatives of the American Bar Association and five representatives of the American Institute of Accountants, at its second meeting held at Chicago September 10th, gave extended consideration to the question of the extent to which the preparation of income-tax returns might be considered the practice of law. The conclusions of the Conference were expressed in the following resolution:

WHEREAS, Lawyers and certified public accountants are trained professional men, licensed by the several states, and required to bring to their public service qualifications both as to competency and character; and

WHEREAS, the American Bar Association and the American Institute of Accountants have adopted codes of ethics to assure high standards of practice in both professions;

BE IT RESOLVED, In the opinion of the National Conference of Lawyers and Certified Public Accountants

1. That the public will be best served if income-tax returns are prepared either by certified public accountants or lawyers.

2. That it is in the public interest for lawyers to recommend the employment of certified public accountants and for certified public accountants to recommend the employment of lawyers in any matters where the services of either would be helpful to the client and that neither profession should assume to perform the functions of the other.

3. That certified public accountants should not prepare legal documents, such as articles of incorporation, corporate by-laws, contracts, deeds, trust agreements, wills and similar documents. Where, in connection with such documents, questions of accountancy are involved or may result, it is advisable that certified public accountants be consulted.

In the discussion, reference was made to the following paragraph in the report of the American Bar Association's committee on unauthorized practice of the law, published as part of the advance program for the annual meeting of the American Bar Association, September 11-14, 1944:

"In the opinion of your committee this law (Revenue Act of 1944) eliminates the necessity for any further attempts to distinguish between simple and complicated income-tax returns and the preparation of all income-tax returns other than the optional ones described above should be construed as the practice of law. Hence, local committees are advised to act promptly to prevent in the future unqualified individuals from holding themselves out to the public as income-tax experts and from making a business of preparing income-tax returns for others."

That this paragraph was not intended to apply to certified public accountants was made clear by the following supplemental statement made by the chairman of the Bar Association committee before the House of Delegates of the American Bar Association on September 14th:

"It has always been customary for the Unauthorized Practice of Law

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Committee to supplement its report by advising the House of any developments occurring during the convention. The House will be pleased to hear that the National Conference Group of Accountants and Lawyers, which you authorized at the mid-winter meeting, held its first business meeting on Sunday of this week.

"The meeting was most successful and a satisfactory basis was established for the future coöperation of the two groups in the public interest. Important resolutions were adopted which I have been instructed by the Conference to report to the House. I will therefore read the resolutions.

"With these resolutions as a basis, the Conference looks forward hopefully to collaborating together for the benefit of the public. In this connection your attention is directed to the report of your Committee which is printed on page 72 of the advance program, where recommendation is made to local and state committees to take vigorous and prompt measures to prevent pseudo tax experts and other unqualified persons from engaging in the business of preparing income-tax returns.

"This recommendation is not pointed at certified public accountants. On the contrary, your Committee recognizes certified public accountants as professional men qualified by education and training to prepare income-tax returns. The report rather is directed against the thousands of unqualified persons who have been engaging in this practice without any educational background or experience for their personal profit as a business, and whose activities are unquestionably against the public interest."

There appears to be judicial authority for the distinction between certified public accountants and "unqualified individuals" which is made by the American Bar Association committee; for example, the Supreme

Judicial Court of the Commonwealth of Massachusetts in the case of *Lowell Bar Association v. Birdie T. Loeb et al* (see *Journal of Accountancy*, February, 1944, page 167) said:

"The proposition cannot be maintained, that whenever, for compensation, one person gives to another advice that involves some element of law, or performs for another some service that requires some knowledge of law, or drafts for another some document that has legal effect, he is practicing law. All these things are done in the usual course of the work of occupations that are universally recognized as distinct from the practice of law. There is authority for the proposition that the drafting of documents, when merely incidental to the work of a distinct occupation, is not the practice of law, although the documents have legal consequences . . .

"The work of an accountant necessarily brings him into touch with rules of law which he must understand if his computations and conclusions are to stand the test of possible litigation. He must know the nature and general legal effect of negotiable instruments, patent rights, corporate stock and bonds of different kinds, insurance policies, and other contracts. He must appreciate the distinction between buying goods, and taking them as bailee, agent, broker, or factor. He could hardly prepare a correct account for a partnership without a working knowledge of the main principles of the law of partnership. In preparing an account for a trust estate, he must understand the difference between principal and income, and the rules of law governing the allocation of receipts and expenses to the one or the other. Income taxes have produced a flood of judicial decisions and departmental rulings with which he must have adequate acquaintance, even though he merely works with figures and does not draft tax re-

Income-Tax Returns and the Practice of Law

turns. A sharp line cannot be drawn between the field of the lawyer and that of the accountant. Some matters lie in a penumbra. But any service that lies wholly within the practice of law cannot lawfully be performed by an accountant or any other person not a member of the bar."

Under this dictum, it may be argued that a certified public accountant whose qualifications to practice accounting have been recognized by the state and who regularly engages in such practice may undertake to do accounting work which is a natural consequence of his practice, such as the preparation of an income-tax return, even though some elements of legal practice may neces-

sarily be involved. His right to do this work, it may be suggested, is reinforced by the express provision of the Treasury Department that certified public accountants may be enrolled to practice before it. However, it may be contended by lawyers that accountants or others whose qualifications have not been recognized by the state through the issuance of a certificate, who are not recognized as members of an established profession, and who are not enrolled to practice before the Treasury Department, engage in the unauthorized practice of the law if they undertake for compensation to assist others in the preparation of income-tax returns involving the interpretation of law or regulations.



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Alphabet Soup but very nourishing!



"Our CPA did a PCA with MM that will eliminate a lot of JACK," said the VP in chg of Acctng. "Excuse it, please. Must be the Washington influence!"

"Does it make sense, or do I need a directive?" asked the Old Man.

"Oh sure—Our brainy accounting chief put in a Production Control Analysis with McBee methods that saves a lot of—"

"Jack. I know that one. Money," said the Old Man.

"Nope—Jawing, Arguing, Cussing and Kicking. Probably save money, too, if you want to be mercenary about it," said the VP.

That CPA knew McBee. McBee knows how to get information to management more quickly, more easily,

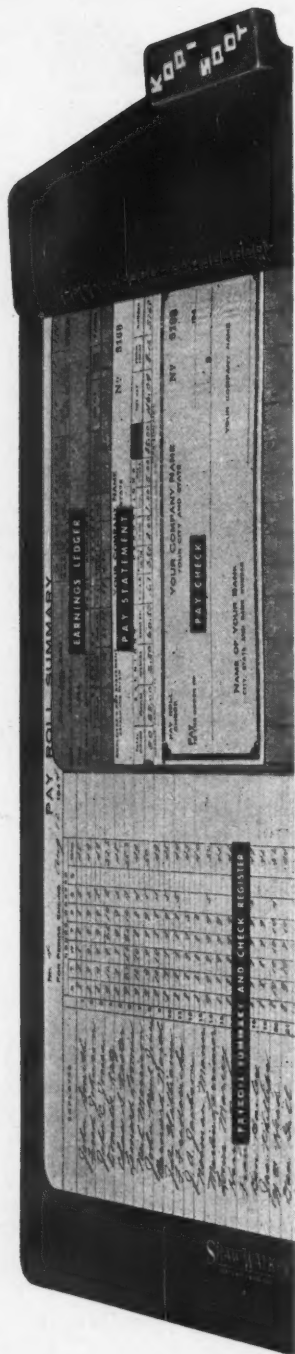
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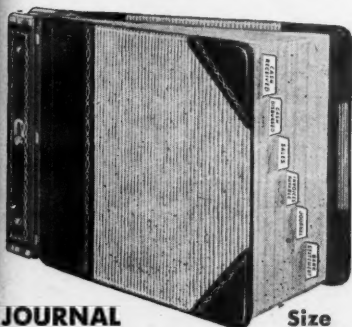


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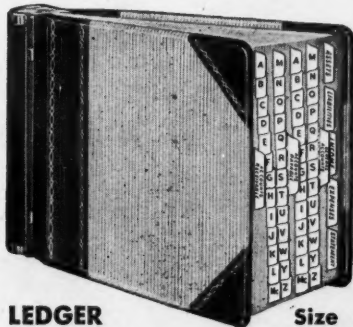
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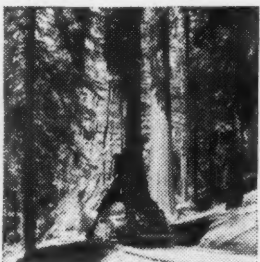
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4 THINGS TO DO to keep prices down and help avoid another depression

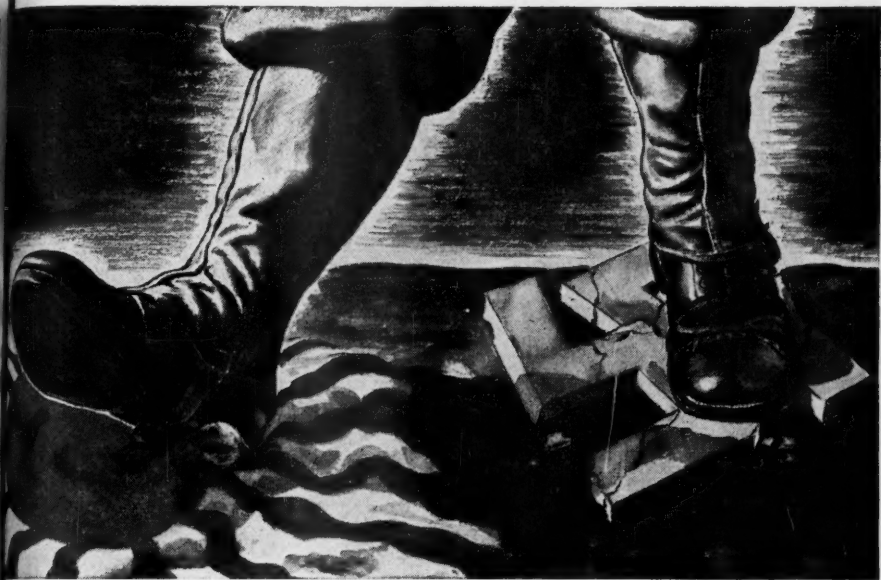
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